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SUBJECT: Trade and Economic Issues Briefing for Assistant Secretary Hill's June 14-18 Visit to Mongolia

Ref: Ulaanbaatar 0228

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(SBU) The following material is provided in preparation for Assistant Secretary Hill's planned visit to Mongolia.

11. (SBU) SUMMARY: Mongolia's economy grew 8% in 2006 (yielding GDP of US\$2.7 billion) and is projected to reach 7.5% in 2007. Mining (copper, coal and gold), cashmere, tourism, and small retail trade were the primary economic drivers, coupled with high world commodity prices. Mining prospects improved recently as a major copper/gold project investment agreement has nearly been concluded, despite last year's ill-considered minerals windfall profits tax. Major U.S. firms have expressed interest in investing in the mining sector, which also holds good promise for U.S. equipment sales. The GOM continues to push for a Free Trade Agreement (FTA) with the U.S., believing this is a politically driven decision. Corruption remains a serious concern, although some progress has been made (an anti-corruption law was passed and is slowly being implemented).
END SUMMARY.

Economy is Booming Despite the Difficulties

12. (U) Mongolia's primary economic drivers are mining (copper, coal, gold), cashmere, tourism and small retail trade and services. High world commodity prices and increased production helped spur 6% economic growth in 2005 and 8% in 2006, and non-mining sectors such as services and agriculture also did well. GDP growth in 2007 is projected to be 7.5%. Per the Government of Mongolia's (GOM) statistics, 2006 GDP amounted to US\$2.7 billion, though the uncounted "gray" market economy may add 40-50% to this figure. (Reftel provides an update and summary on Mongolia's economy.)

13. (U) Economically, Mongolia faces daunting challenges: It is landlocked, with a severe continental climate, and sparsely populated. The size of Alaska with a population of 2.8 million (about the size of Denver City), nearly 40% of the population (one million) lives in the capital city, Ulaanbaatar (meaning "Red Hero" courtesy of the Russians). Over the last decade, about 20% or so of Mongolia's population abandoned countryside herding and migrated to the capital where they live in "ger" (yurt in Russian) suburbs surrounding Ulaanbaatar. A bit less than 40% of the country's population still makes a living from nomadic livestock (sheep, goats, cattle/yak, camels, and horses, of which there are 33 million).

14. (SBU) Mining is of paramount importance to Mongolia's current and future business and investment climate, and offers the U.S. the best opportunities for investment and for exports of U.S.-origin goods and services. Two major U.S. mining firms, Peabody Energy and Phelps Dodge, have opened or are opening offices in Mongolia to pursue coal and copper investment opportunities, respectively. In addition, there are other opportunities for exports of goods and services to the mining sector. Caterpillar, for instance, has a flourishing distributor supplying the sector. Peabody, the world's largest coal only mining company, is very interested in coming in as part of a consortium to develop the large Tavan Tolgoi coal deposit near the Chinese border. The Mongolians who own the exploration rights to the deposit need to settle on the consortium details, then begin discussions with the government. Ivanhoe (Canadian) and Rio Tinto (UK-Australian) have paired up and are poised to conclude an investment agreement with the GOM to develop the world class Oyu Tolgoi copper and gold deposit also near the border with China.

15. (U) However, mining development is a subject of domestic political controversy. Mining does not directly create many jobs and many of the locally developed, non-foreign invested mines are operated in an environmentally destructive manner. The largest of these mines -- the joint Mongolian-Russian (51%/49%) Erdenet Copper Mine and the Canadian-owned Boroo Gold Mine -- have been the target of a nationalistic backlash centering on the theme, "Why are so many Mongolians poor while foreign companies are profiting from our mineral resources?"

16. (SBU) In May 2006 the GOM, without consulting stakeholders and much to their surprise, hastily enacted a windfall or "excess

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profits" tax on copper and gold to find money to fund expensive populist campaign promises for monthly child stipends and a 30% pay hike for civil servants. In July, Parliament passed amendments to the Minerals Law which allowed the GOM to take up to 50% equity of any mine deemed "strategic" if discovered through state financing, 34% of any mine discovered through private funds. While foreign mining companies didn't close up shop, exploration virtually stopped as confidence plummeted. The seventh annual Fraser Institute Survey of Mining Companies recently listed Mongolia as 62nd out of 65 countries in attractiveness for mineral exploration, down from 33rd the previous year, attributed to regulatory problems and a lack of openness.

17. (SBU) Things have moved in a somewhat more positive direction in recent months, beginning with the appointment of a well-regarded technocrat to head the new government mine equity holding company. The GOM and Ivanhoe/Rio Tinto have reached an ad ref agreement on the long-stalled Oyu Tolgoi copper and gold mine. As part of the deal, the government would get 34% of the mine equity, but pay for it out of its share of the mine profits. The Tavan Tolgoi coal mine looks to be next up for a deal, but sorting out the local ownership, the government share, and the share of foreign companies -- many of which are beating on the government's door to do a deal -- may take a while.

They Want an FTA, We Want Transparency, Let's Deal

18. (SBU) Mongolia wants a Free Trade Agreement(FTA) with the U.S., arguing that this would be a political and economic endorsement of our very friendly bilateral relationship. GOM officials constantly recall the U.S. FTA with Jordan. At the third Trade and Investment Framework Agreement (TIFA) talks in March, Mongolian trade representatives continued to lobby for a roadmap by the end of 2007 towards an FTA with the U.S. However, trade volumes are low and there is no major U.S. business support for an FTA. Moreover, Mongolia's legislative and regulatory systems affecting commercial activities need significant and real reform before any comprehensive trade agreement is even contemplated.

19. (SBU) At the March TIFA talks, Assistant USTR Tim Stratford

instead recommended focusing on near-term steps to improve trade and promised to report back to the GOM with a suggestion for a concrete step. We expect that step to be unveiled to the GOM next week, before A/S Hill visits. Although still in development, this concrete step may deal with the crafting of a transparency agreement similar to transparency chapters in existing FTA agreements. As a mark of our sincerity and a test of the GOM's commitment to reform, this would address one of our major concerns about Mongolia's business climate, while also being a step which could correctly be described as a major cornerstone for any future decision to try for a bilateral FTA.

Corruption Is a Problem

¶10. (SBU) Corruption continues to plague Mongolia's business and investment climate. Transparency International ranked Mongolia 99th out of 163 nations on its 2006 Corruption Perceptions Index (CPI), dropping the country 14 points from the previous year.

¶11. (SBU) This is a time of transition for Mongolia. We applaud the passage of the Anticorruption Act last July. While there is considerable room for improvement, the Act gives Mongolia important new tools to fight corruption. The Anti-Corruption Agency (ACA) is beginning operations, and is just starting to get the first asset and income disclosure forms from officials. The GOM needs to fully fund and staff the ACA and give it political support to conduct operations. USAID has a small anti-corruption program, through The Asia Foundation, which works with the ACA, primarily on public education and involvement in anti-corruption efforts.

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